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July 9, 1996

William F. Caton  
Secretary  
Federal Communications Commission  
1919 M Street, N.W. - Room 222  
Washington, D.C. 20554

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JUL - 9 1996

Federal Communications Commission  
Office of Secretary

**RE: Ex Parte Notice  
CC Docket No. 96-98**

Dear Mr. Caton:

On July 8, 1996 United States Telephone Association representatives met with members of the Common Carrier Bureau. The USTA group consisted of Bob Blau (BellSouth); Ed Lowry (Bell Atlantic); Bill Taylor, Chris Cichoski and Chienyo Fung of NERA; and John Hunter of USTA. Peyton Wynns, Jim Lande, Doron Fertig and Tom Beers from the Industry Analysis Division attended the meeting.

The discussion centered on the information contained in the attached which was shared at the meeting. This information is also part of the comments USTA filed in this docket, and the discussion was consistent with these comments.

Because of the lateness of the meeting, this notice is being filed today. An original and one copy of this ex parte notice are being filed in the Office of the Secretary. Please include this notice in the public record of these proceedings.

Respectfully submitted,

A handwritten signature in cursive script, reading "Mary McDermott".  
Mary McDermott  
Vice President -  
Legal & Regulatory Affairs

attachments

cc: B. Blau J. Lande D. Fertig  
B. Taylor P. Wynns T. Beers  
E. Lowry C. Cichoski J. Hunter  
C. Fung

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# **The IDSS Model - A Critical Evaluation**

National Economic Research Associates

July 8, 1996

## Scope of the IDSS Model

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### Determinants of LEC Revenue by Category

End Users	CLEC	IXC
<ul style="list-style-type: none"><li>• Total Bill - Residual</li><li>• Business - Residence</li><li>• Special Access</li></ul>	<ul style="list-style-type: none"><li>• Facilities Based - Unbundled</li><li>• Traditional - CIC Access Rates</li></ul>	<ul style="list-style-type: none"><li>• Bypass</li></ul>

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## **The Model Oversimplifies the Telecommunications Industry**

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- A single aggregate LEC masks different effects on real-world LECs and produces a biased prediction of the total industry effect.
- Does not explicitly model local interconnection or resale of LEC retail services.
- Prices and market shares are not linked.

# Model Contains Numerous Arithmetic and Coding Errors

A					
Panic Expense Reduction Part 1	0.0000				
Panic Expense Reduction	0.0000				
Base Line Depreciation	0.06954	0.069316	0.069531	0.070871	0.073
Actual Depreciation Rate	0.06954	0.069316	0.069531	0.070871	0.073
Increase in Depreciator	0.278006	0.308269	0.454561	0.448006	0.56
Growth Rate in Other Taxes		1.0%	1.5%	-0.4%	1.0%
Interest Expense as per	3.0%	2.7%	2.6%	2.4%	2.5%
Effective FIT rate	31.0%	32.4%	31.8%	33.1%	33.3%
Shareholders equity as	49.8%	49.3%	46.6%	45.7%	46.0%
Operating Expense	\$67.9	\$68.0	\$71.2	\$71.7	\$74.4
Annual Depreciation	\$18.1	\$18.6	\$19.3	\$20.3	\$20.3
Operating Profit	\$23.6	\$25.1	\$25.4	\$27.4	\$27.4
year over year changes		1.4%	1.1%		1.1%
Margin on total bill					\$0.0
Gross Plant worksheet					
Replacement investment (and special access)		\$12.6	\$13.4	\$12.0	
Retirements offset by new investment		\$10.5	\$11.2	\$9.2	
Net Replacement Investment		\$2.1	\$2.2	\$2.8	
Prior year gross plant		\$272.1	\$282.0	\$201.5	
Investment for net added business lines		\$1.5	\$5.3	\$7.6	
investment for net added households with serv		\$8.0		\$6.6	
investment for net added additional residential		\$0.2		\$1.0	
investment for added minutes hitting LEC switch		\$0.7		\$0.7	
investment for vertical services		\$2.2		\$0.5	
investment for Special Access		\$0.0	\$0.1	\$0.0	
investment for Private Line services		\$0.1	\$0.1	\$0.0	
investment for 'other' and Misc. services		\$0.1	\$0.0	\$0.1	
investment for added toll minutes		\$0.0	\$0.0	\$0.0	
investment in shadow or stranded loops (to off		\$0.0	\$0.0	\$0.0	

B					
Proprietary customers unbundled loops					
Proprietary Rate Index	\$0.0010	\$0.0003	\$0.0028	\$0.0073	\$0.0044
Residential Rate Index	\$0.0010	\$0.0003	\$0.0028	\$0.0073	\$0.0044
Basic + SLC	\$59.7	\$61.6	\$61.9	\$64.2	\$67.0
Access & Inter	\$19.7	\$20.4	\$19.9	\$20.7	\$21.8
Unbundled	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
All other op	\$18.3	\$18.7	\$20.1	\$20.5	\$21.0
LEC High co	\$0.7	\$0.7	\$0.7	\$0.7	\$0.7
Total LEC R	\$97.7	\$100.7	\$101.8	\$105.4	\$108.9
Total Expen	\$71.2	\$71.7	\$74.4	\$76.7	\$79.3
Net Rate B	\$167.3	\$167.7	\$167.7	\$176.5	\$186.9
Rate of return	12.5%	14.0%	14.1%	14.2%	13.7%
% lines lost	0.0%	0.0%	0.0%	0.0%	0.0%
% lines lost	0.0%	0.0%	0.0%	0.0%	0.0%
Traditional	375.6	401.2	434.9	488.3	508.3
Theoretical	375.6	401.2	434.9	488.3	508.3
Interstate m	375.6	401.2	434.9	488.3	508.3
LEC EBITDA	44.83389	48.0384	49.03575	51.5483	53.8821
Total Loops	147.0858	152.4294	158.373	164.0811	170.0888
EC Loops	152.4294	158.373	164.0811	170.0888	176.331082
Proprietary customers unbundled loops					
Total CLEC households	0.000	0.000	0.000	0.000	0.000
Total 'All LEC' customers	0.000	0.000	0.000	0.000	0.000
Total 'proprietary' households	0.000	0.000	0.000	0.000	0.000
Regulated as a percent of total house	0.0%	0.0%	0.0%	0.0%	0.0%
Toll minutes billed to customers (billions)					
Interstate					
on residual customer lines		104.911	112.505	123.245	123.245
on CLEC lines		0.000	0.000	0.000	0.000
on LEC total bill lines		0.000	0.000	0.000	0.000
Total		104.911	112.505	123.245	123.245
InterLATA interstate					
on residual customer lines		35.055	41.628	41.628	41.628
on CLEC lines		0.000	0.000	0.000	0.000
on LEC total bill lines		0.000	0.000	0.000	0.000
Total		35.055	41.628	41.628	41.628

C					
Net Cost Assumptions					
Additional LEC marketing Expense when unbundled loops > 10%					
Residential					\$0.0
Business					\$0.0
Additional LEC marketing expense when they go into DCM markets					
Residential					\$0.0
Business					\$0.0
Inflation in the whole eco	0.039	0.038	2.8%	2.3%	2.9%
Special LEC productivity adjustment					2.0%
DC Annual productivity reflected in rates					3.0%
Expense, Plant and Income Data (billions)					
Annual Depreciation	\$18.1	\$18.6	\$19.3	\$20.3	\$21.7
Other LEC Operating Exp	\$49.8	\$49.5	\$51.9	\$52.4	\$52.7
Total LEC Operating Exp	\$67.9	\$68.0	\$71.2	\$72.7	\$74.4
Earnings Before Interest	\$23.6	\$25.1	\$25.4	\$27.4	\$27.4
Interest and related item	\$4.8	\$4.5	\$4.3	\$4.1	\$4.1
Other Taxes (including misc.)	\$4.7	\$4.8	\$4.8	\$4.8	\$4.9
Income & Related Taxes	\$4.4	\$5.1	\$5.1	\$5.3	\$5.1
After Tax Profit	\$9.7	\$10.7	\$11.1	\$12.6	\$12.3
LEC Gross Plant (Acct)	\$263.7	\$272.1	\$282.0	\$291.5	\$303.4
Accumulated Depreciation	\$700.2	\$705.9	\$714.7	\$723.6	\$735.7
LEC Net Plant (Acct 35)	\$163.5	\$166.2	\$167.3	\$167.7	\$167.7
Total other liabilities and	\$38.2	\$40.9	\$46.3	\$51.9	\$50.8
Rate Base	\$125.3	\$125.2	\$121.0	\$115.6	\$116.8
EBITDA (Earnings before interest, taxes, depreciation & amortization)	\$41.70	\$43.67	\$44.63	\$48.01	\$48.09
LEC Shareholder Equity	\$81.50	\$81.69	\$77.99	\$76.66	\$77.13
Ratio					
Rate of return on Model Rate B	12.1%	12.5%	14.0%	14.1%	14.1%
Return on Equity	11.9%	13.1%	13.8%	16.3%	15.9%

## Model is Sensitive to Assumptions with a High Level of Uncertainty

Unknowable Fact	Change in Assumption and Resulting Effect on EBITDA
Spec 26 -- Business Local Rates First Year of CLEC Competition	A decrease of 10% from -2.6% results in a loss of <b>\$1.5 billion</b> for the LEC.
Spec 73 -- % CLEC Loops Provided With CLEC's Own Facilities	An increase of 20% results in a decrease in LEC earnings of <b>\$5.6 billion</b> .
Specs 79 and 80 -- Percent of LEC "Total Bill" Customers	An increase of 10% starting in 1997 increases LEC earnings by <b>\$6 billion</b> .
Specs 117 and 118 -- Total added LEC marketing expense when unbundled loops exceeds threshold: Residence and Business	An increase of \$5 billion results in a <b>\$10.6 billion</b> decrease in LEC earnings
Specs 119 and 120 -- Total added LEC marketing expense if LEC share of "total bill" customer loops exceeds threshold: Residence and Business	An increase to \$5 billion from \$0 results in a <b>\$10.8 billion</b> decrease in LEC earnings.
Base Case is the n/e/r/a base case. All changes in earnings are based on EBITDA for the year 2006.	

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## **...but the Model Shows Substantial Impact of Potential Policy Decisions**

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- Base Case: Local and interstate toll competition in 1997 with reasonable interconnection policies.
- Scenario 1: Cheap interconnection, resale and unbundled loops.
- Scenario 2: Same as Scenario 1 with bypass of terminating access.
- Scenario 3: CLEC purchases all network elements at low TSLRIC.
- Scenario 4: Same as Scenario 3 with bypass of terminating access.

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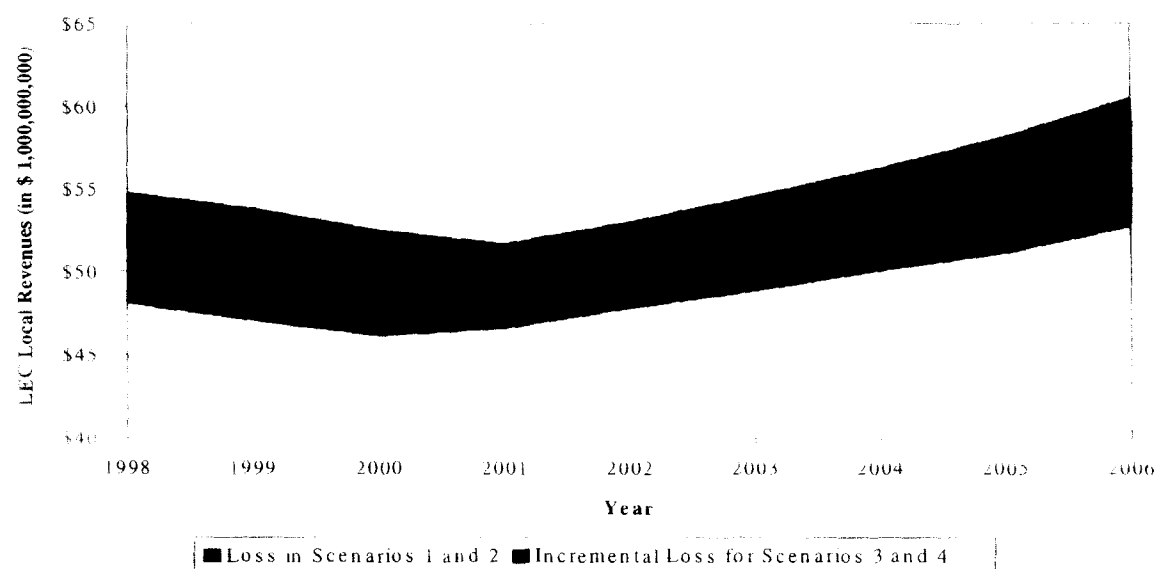
## Figure 1: Predicted Loss in LEC Lines from the Base Case

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## Figure 2: IDSS Forecast Changes in LEC Local Revenues from Base Case



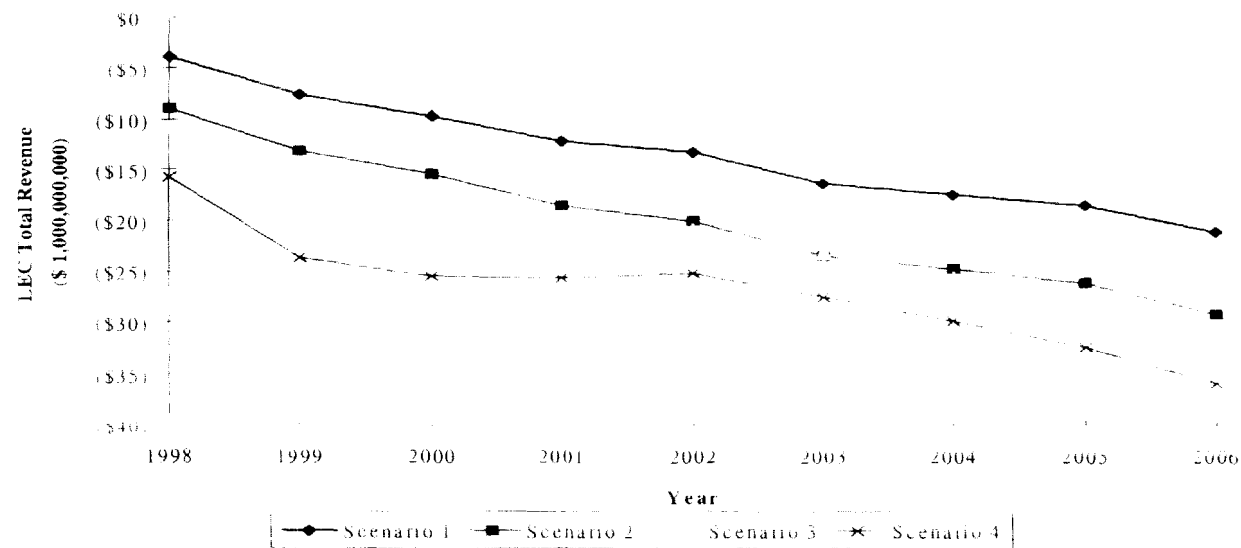
## Figure 3: IDSS Predicted LEC Toll Revenue Losses from Base Case



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**Figure 4: IDSS Predicted LEC Total Revenue Losses from the Base Case**

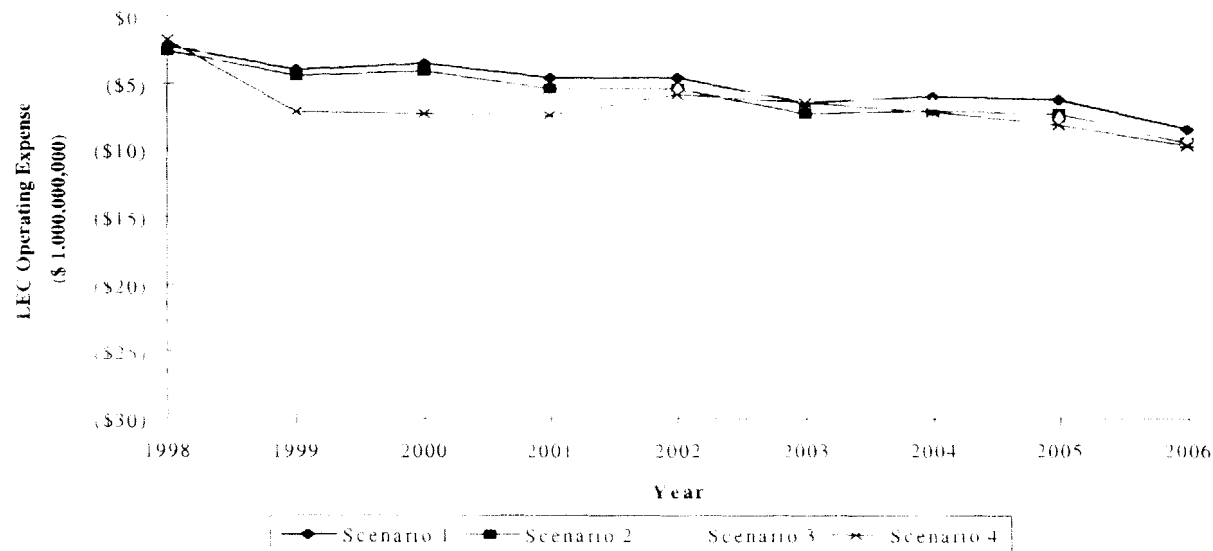
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**Figure 5: IDSS Predicted Difference in LEC Operating Expense from Base Case**

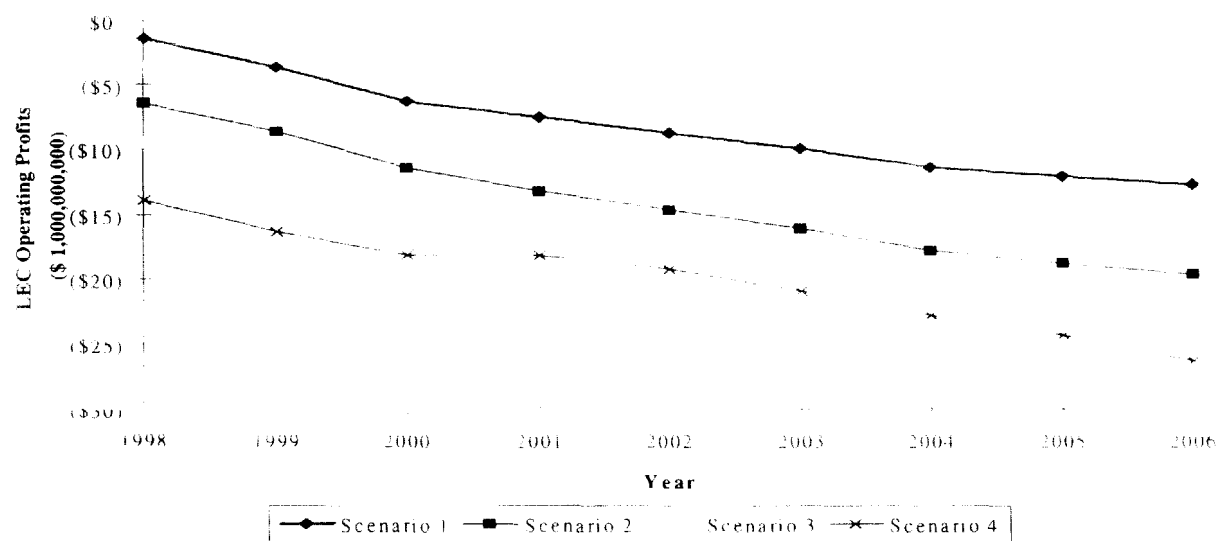
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**Figure 6: IDSS Predicted Difference in LEC Operating Profits from the Base Scenario**

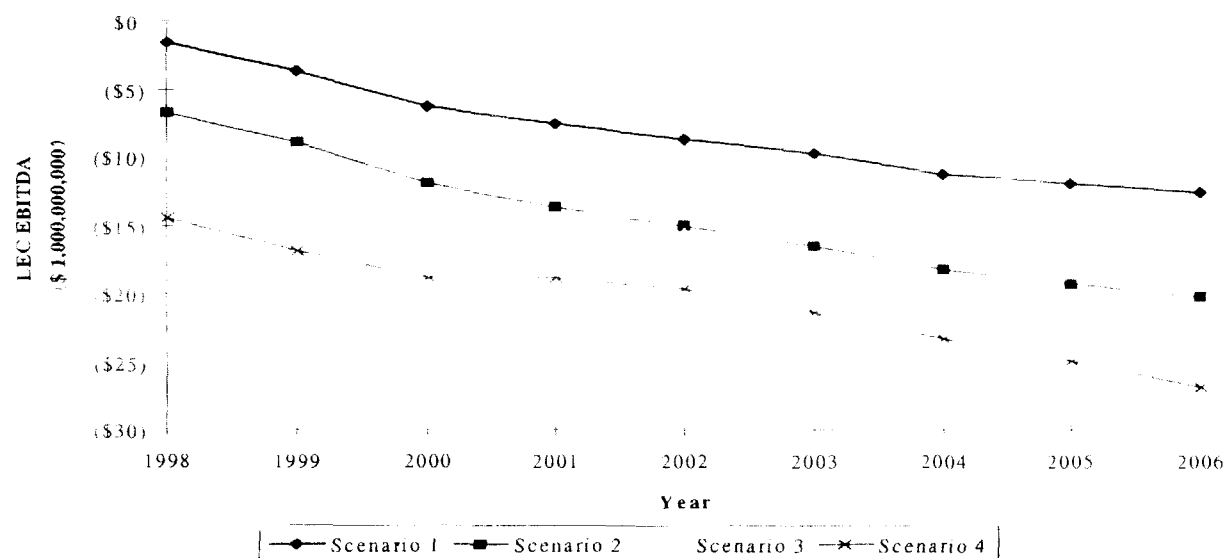
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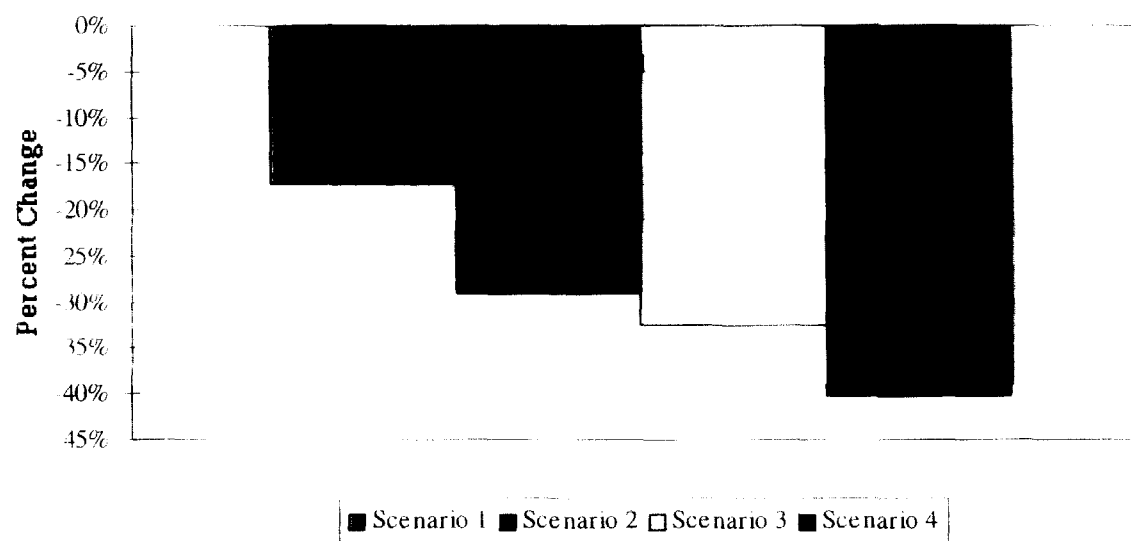
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**Figure 7: IDSS Predicted Losses in LEC EBITDA from the base case**

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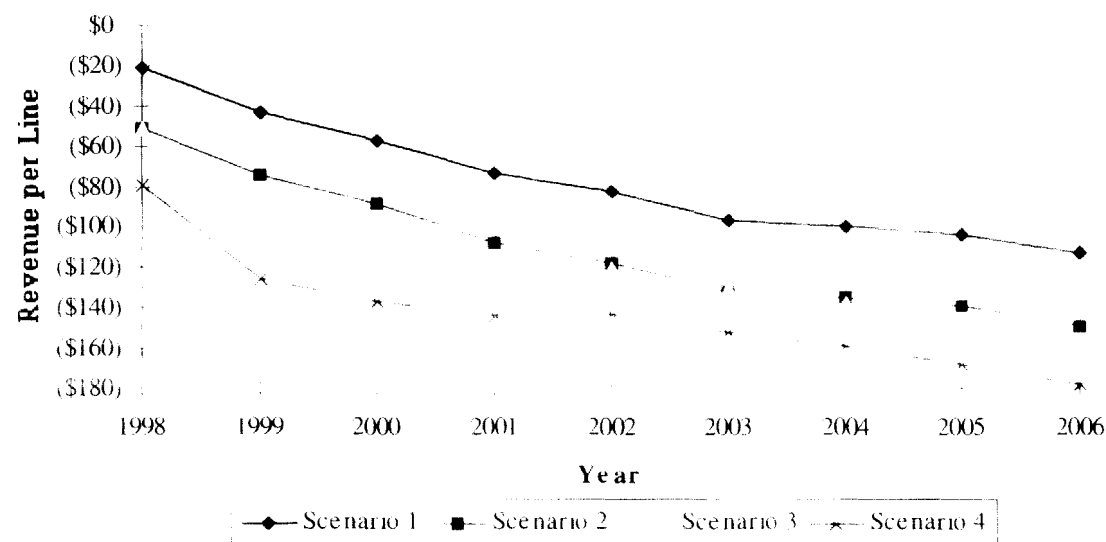
# Figure 8: Potential Decline in LEC Equity Value from Base Case



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**Figure 9: IDSS Predicted Loss in Revenue per Line from the Base Case**

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**Economic and Financial Simulation  
of the Effects of FCC Policies on  
Local Exchange  
Unbundling and Resale**

## Model Overview

- Purpose: Assess economic and financial implications to Large LECs of FCC policies re: pricing of unbundled loops, local exchange resale, and terms and conditions for CLEC purchase of unbundled elements
- Method:
  - Establish a Baseline View that represents the current estimates of investment analysts
  - Simulate the financial performance of a composite of the large LECs based on sets of possible FCC policy decisions
  - Compare the simulations with the Baseline View

## Scenarios Compare LEC Financial Results to the Baseline View

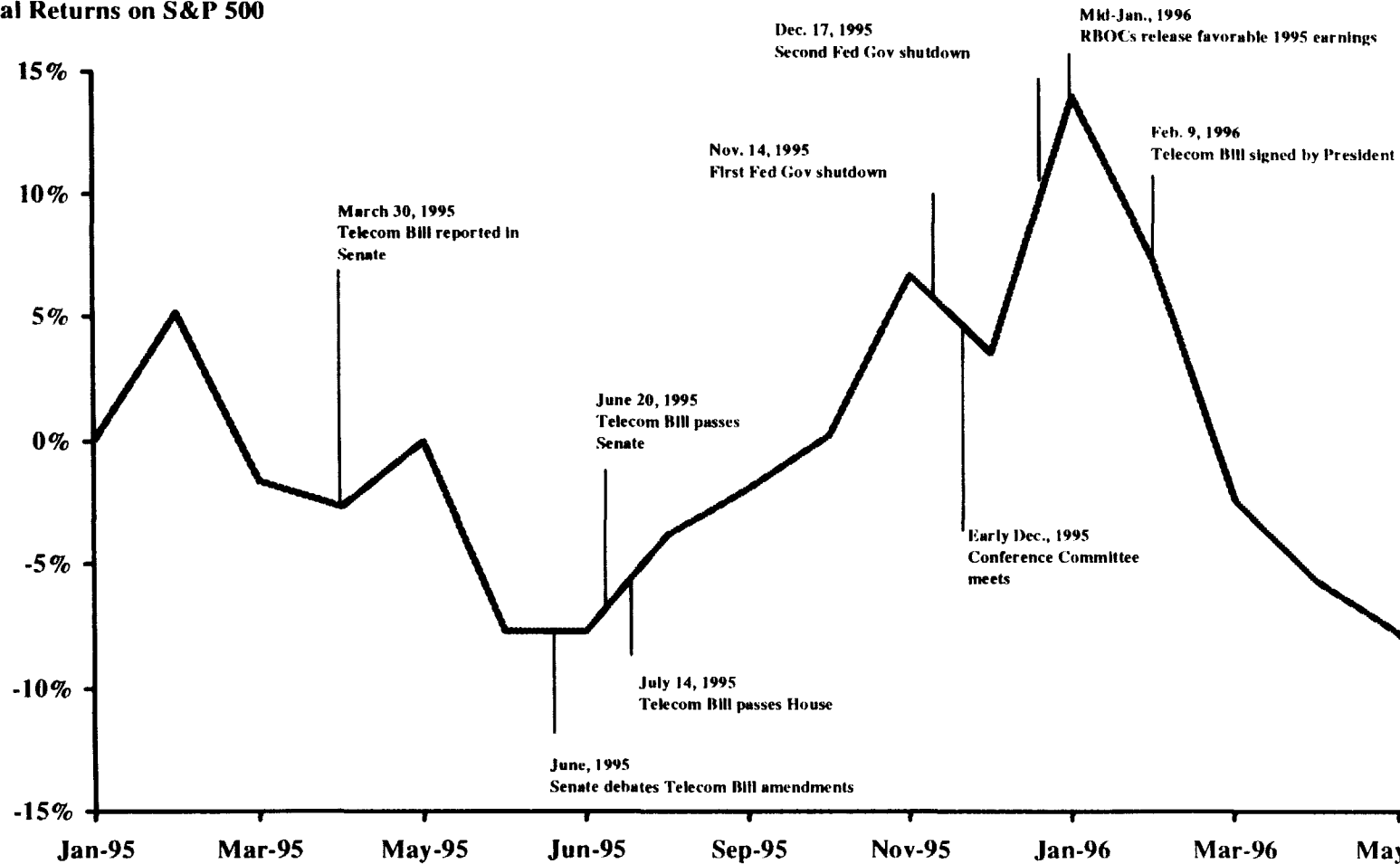
- **Scenario 1:** low prices for unbundled loops and high resale discounts;
- **Scenario 2:** identical to *Scenario 1*, but with the addition of total bypass of terminating access charges;
- **Scenario 3:** recombination of unbundled LEC elements purchased by competitors at incremental cost (loop and other basic exchange service elements prices based on Hatfield);
- **Scenario 4:** identical to *Scenario 3*, but with the addition of total bypass of terminating access charges

## Baseline View

- Financial markets reflect the market's perceptions of the implementation of the Telecommunications Act.
- Since December 1995:
  - Large LEC stock prices have dropped 5% in nominal terms
  - Cost of capital increased nearly one hundred basis points
  - Market capitalization has declined by \$12 billion
- Industry analyst projections incorporate expected LEC market share loss but do not account for crucial detailed issues which industry specialists and the RBOCs are just beginning to grapple with:
  - Unreasonably low unbundled loop prices
  - Unreasonably high resale discounts
  - Recombination of low priced network elements and resulting switched access bypass

# Cumulative Total Returns of the Large LECs Relative to the S&P 500

Total Returns on S&P 500

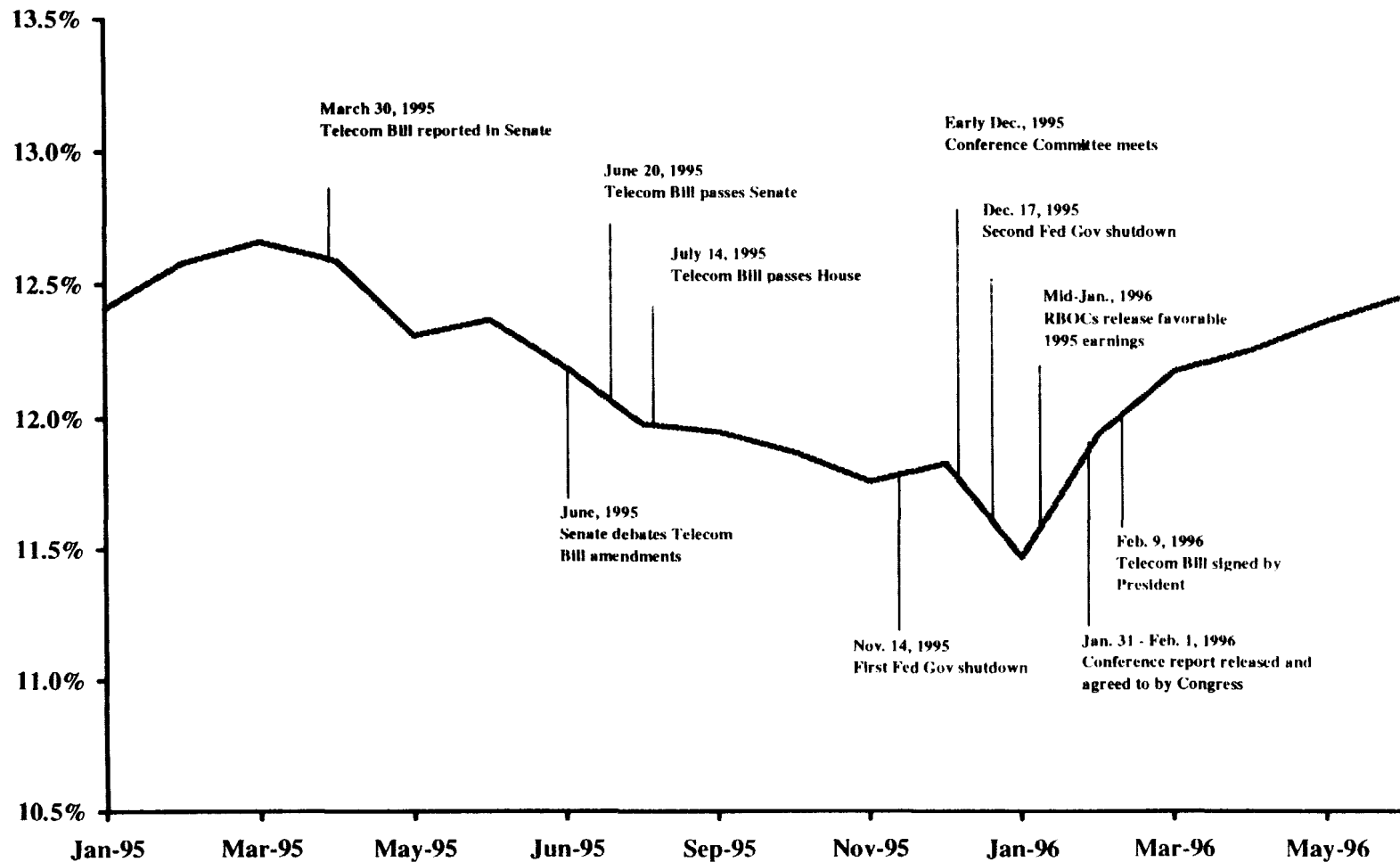


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# Average Estimated Cost of Capital for Large LECs

Estimated Cost of Capital



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## Key Assumptions - Customer and Competitor Behavior

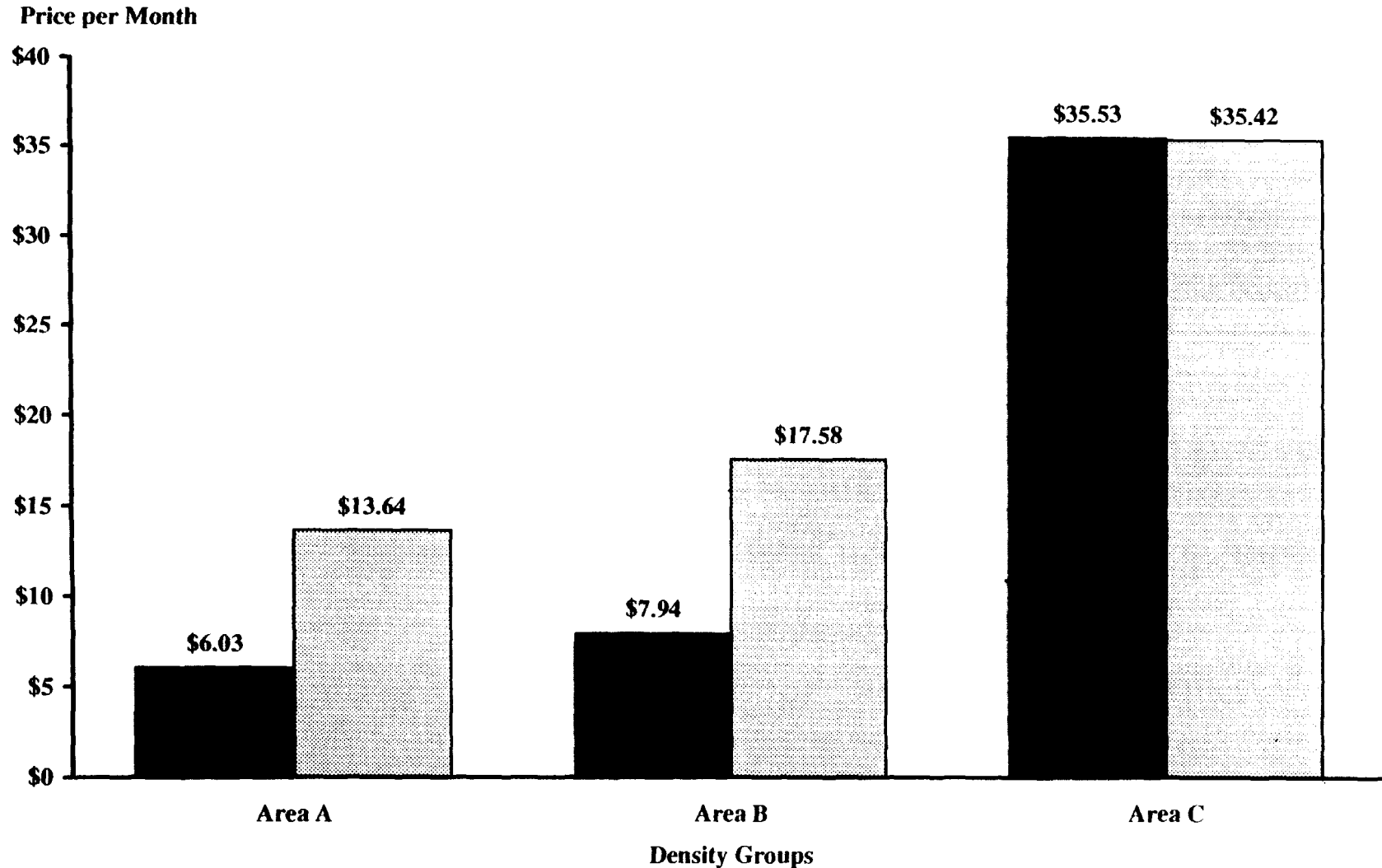
- **Customer Behavior:** Customers that choose a LEC competitor for local exchange service will purchase all local and long distance service from that competitor.
- **Competitor Behavior:**
  - Competitors will target the highest revenue and lowest cost customers. For the large LECs, 65% of their business revenue is generated by the top 10% of the business customers.
  - The majority of competitors' local exchange lines will be leased from the LECs rather than installed by competitors.
  - With reasonably priced loops, the percentage of competitor supplied, facilities-based loops will increase.

## Key Assumptions - Prices

- Prices for unbundled network elements based on TSLRIC estimates vary according to geographic density
  - More dense areas have lower costs and therefore lower unbundled prices
- Hatfield estimates of the TSLRIC for unbundled loops and basic local exchange service are unreasonably low
- Prices for unbundled loops should be based on reasonable estimates of TSLRIC and include some contribution to other costs
- The local resale discount should be based on reasonable estimates of avoided costs



# Alternative TSLRICs of the Local Loop



■ All Scenarios

▨ Baseline

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